DENVER BUSINESS JOURNAL

TABLE OF EXPERTS

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COMMERCIAL REAL ESTATE

• ROUNDTABLE •

The Denver Business Journal's Commercial Real Estate forum on June 19 produced major trends and deep insights from three industry experts.

One panelist captured the reason behind holding the forum: "What's so surprising to me is how fast we've gotten to where we're at," said Pete Schippits, senior managing director and market leader for CBRE in Colorado.

The panel also included Allison Recker, senior vice president of commercial real estate finance at UMB Bank in Denver, and Jay Philp, a partner in the real estate group at the Denver law firm of Otten Johnson Robinson Neff + Ragonetti.

Pete Casillas, President and Publisher of the Denver Business Journal, served as moderator.

In what sectors in the commercial real estate market do you expect to see the most growth this year?

ALLISON RECKER: Most property types are continuing to trend in a positive direction. However, I think with the recent changes to condo construction-defect legislation, there may be growth in the development of more affordable condo units. If more affordable or market-rate units are built, it will be interesting to see the impact it has on the multifamily market.

JAY PHILP: We're seeing that start, condo-development beginning well below that luxury level, which is nice. It's being introduced in smaller doses and low-basis areas. We're definitely seeing people test the waters. My suspicion is that before we see a lot more of that, we're going to have to see insurance rates start to drop.

We'll have to see some claims activity that responds favorably to the legislation and the Vallagio case, before premium rates drop. And then I think we'll see more and more people dive in, and more lenders get comfortable with it as well.

Are clients asking for additional opinion on how the recent law will be interpreted by courts – with respect to arbitration - and will we continue to see lawsuits? Have you heard of any developers trying to get a sense of where the legal winds are blowing?

JAY: All of them are. I think people are starting to feel really comfortable, based on Supreme Court activity, that arbitration provisions will be upheld with respect to claims against developers. There are a lot of other issues that come into play in making construction-defects risk tolerable. Many municipalities are trying to enact local legislation. There are questions about whether those will be enforceable with respect to state pre-emption. That's very difficult to predict. I think that's the reason we're starting to see only a slow trickle into the affordable condo market right now.

Which industry is piquing the interest of CRE investors right now? Why?

PETE SCHIPPITS: CBRE does a survey of our investor-clients every year. For the first time in a handful of years, we've had a replacement for multifamily being the top asset class. It's actually industrial right now. We've had a huge run of industrial in Denver, 29 consecutive quarters of positive absorption, which is pretty much unheard of.

We're also seeing fairly measured development. CBRE Research also has done another survey, internally, and Denver is the top market in the country for preleasing speculative warehouse space, so it just shows the pent-up demand we have here.

How healthy does the hospitality sector look going forward?

JAY: It looks good. I would say that the hospitality market is locally submarket-driven, both in Denver and in other areas in the country. Probably more than half the work I do is outside the Denver metro area. So, we see pockets of heat that are scattered around. There is an increasing focus on critical mass-sized hotels (100 rooms or more) and resorts, moving away a little bit from the boutique-sized resorts. Seeing a path to increased profitability is a little bit easier when you have more keys to distribute your costs across. Also, I think everybody's very carefully watching lenders right now. I think this is the most volatile asset class within the commercial real estate sector. When lenders start to tighten up, then, all of a sudden hospitality assets that looked interesting become distressed in the market.

What are current trends and innovation in retail affecting the CRE market here in Denver and perhaps more broadly?

PETE: What we're noticing is a shift to experiential retail. That, and shared-space retail replacing some of the big-boxes that used to be traditional walk-in, purchase your goods stores. Former big-box spaces are now turning into trampoline parks and rock-climbing gyms and WhirlyBall facilities, things we hadn't seen before. Also, shared-space concepts, such as Avanti and Stanley Marketplace, have really taken off, symbolic of how retail is converting.

There's an article about those empty suburban malls attracting some health care facilities, emergency care, even clinics and hospital lights in those big spaces. It makes sense a little bit, but it's bizarre. That might be commonplace moving forward, re-using those spaces.

PETE: We're waiting to see if that converts into industrial, actually. There's some push-back on the municipal side from the tax side of things. They really like to see retail. But from a practical sense, some of those big, kind of traditional power centers could be great distribution facilities for industrial.

JAY: Some of the smaller tenants may not be excited about having an industrial facility in there. That's not the anchor that traditionally draws in a lot of foot traffic. Nor is a hospital or medical office, though we're seeing some hospital and medical office development in and around retail centers, both new retail centers and older centers.

Does it change the behavior of any of the traditional actors in a mode like that, or is that just a natural evolution? Does it just change the historical kind of way that parties interact with one another?

PETE: It's Free Marketplace 101. The way I see it is we have a lot of new investors that want to get into a city like Denver, and they don't have established channels. The competition has increased because we have new players here. Therefore some different structures, as Jay is highlighting, become more prevalent. You've got more groups – I don't want to say, willing to take more risks – rather, it's a better distribution of the risk. What makes sense on a practical standpoint is that you're paid to perform. You really created that opportunity and it delivered a good return to the investor, and you're seeing groups being paid at a proportionately higher amount. … It's certainly creating more of a free marketplace for those that are trying to get in.

Is the multifamily sector in danger of being overdeveloped in Denver?

ALLISON: This has been a continued topic of discussion for the past four years. Properties are still being delivered and the product continues to be absorbed. That being said, concessions are being seen in the market and vacancies have been creeping up, especially downtown.

I do think that while things will soften, there won't be any significant harm to the multifamily market. There's so much in-migration and strong foundations in that regard, the units continue to be absorbed. How many people though can continue to pay $2.50 a square foot for an apartment project? That's where it'll be interesting to watch over the next several months or years.

Do you look at these TOD (transit oriented development) opportunities, with the build out of the lines, in a slightly different manner than you would the Central Business District?

ALLISON: With all the population growth we've seen, traffic continues to be an issue. I do think that having TOD developments is very desirable. The downtown core is saturated with multifamily, but there are certain pockets where development projects make sense.

PETE: We're trying to look at what kind of city Denver is going to be, and one of the stats CBRE looks at is number of jobs per apartment built. Over the past 16 years, we've seen that ratio drop. Denver was up to about 16.4 jobs per apartment downtown if you go back 15, 16 years ago. We're now down to about 5.7 jobs per apartment. We feel like a good, healthy number is going to be around five jobs per apartment.

Denver has made up a lot of ground. There's also pent-up demand; we weren't delivering product from 2004 to about 2012 at nearly the pace to keep up with the in-migration. … If the job market stays as healthy as it is, and you continue to see relocations of companies with very high-paying jobs coming to Denver, we'll be fine.

JAY: One of the things that some of our groups are looking at is in-migration especially in the 18-to-34 age demographic. It's been a great sweet spot and we hope that they'll continue. … There are some concerns that our cost of living is starting to creep up to the point that maybe areas like Portland start to look relatively more attractive.

Are there ways you've had to change trying to place money in deals because of the nature of the equity market here?

ALLISON: We focus on the people behind the project, then we focus on the project and the location.

I'm trying to make sure if there's anything that's unique about the balance between debt and equity that's in the market right now in Denver that's worth telling.

ALLISON: Highly Volatile Commercial Real Estate (HVCRE) regulations have come into play, which impact the level of upfront equity required for construction loans. We're generally seeing more upfront equity in deals.

PETE: That does tie in with the previous topic. Then you have to find more capital for your deal. That does tend to drive up your cost of capital a bit.

Who are the new investors targeting Denver, and why are they looking here?

PETE: Additional foreign capital sources is what's been most exciting, as it sort of legitimizes you as a city when you start to get the rest of the world investing. We had Bahrain and Sweden last year, which we hadn't seen before. Germany is hot. South Koreans are buyers. It's a very diversified pool. It really brings us not quite to the coastal levels yet, but darn close. They don't maybe have as high an allocation for a city like Denver, but they like the diversified nature, the in-migration, the millennials, the workforce, low unemployment. The fundamentals look great for us. We'll see how these investors' returns deliver, but we've at least seen them get past the stage of just kicking tires, if you will. We don't see that slowing. If anything, it's growing.

Have you had any interesting deals with out-of-market investors in Denver? ...market investors in Denver?

JAY: We saw some South Korean investment prior to the last downturn. A handful of deals that I happened to be aware of involving South Korean investment just cratered in the downturn. Their investment was at the worst possible time. They're looking for different types of assets now; they're not going after spec land plays. We've certainly seen a lot more coastal fund money coming into Denver throughout this cycle, and it still seems to be, despite the feeling that we're at, or near (or in some areas past) peak a little bit. We're still seeing that coastal money coming in. People still seem to like the demographics, which hopefully is good news.

PETE: Also, from a returns basis, the returns have gotten pressed so low on the coast that you'll see people –- especially 1031 exchange money – that's creeping up in value. Our private capital space is pushing into what used to be considered institutional-only in terms of value size. We see that from California a lot, as investors will trade out of something there and trade into Colorado because they can get a couple of points higher on the return.

How is ecommerce impacting the industrial market, and do you expect industrial construction to slow? And we didn't talk about the marijuana effect, the space they take up.

PETE: We saw big runup as marijuana became legalized and did lease a lot of space. It was primarily lower, less-quality industrial space. Lower ceiling height, but yet high-power, Class B and C space. We went through a couple years of that, which drove up values pretty significantly.

The news is that the industry was absorbing a product type in the marketplace that typically would be last to lease. This helped the health of the overall industrial market, especially in the wake of the recession. But we don't actually see dramatic growth continuing; CBRE Research shows that the marijuana industry footprint is pretty well-stabilized.

To consider how the overall industrial market is impacted by ecommerce, think of our region as a bit of an island and Denver is at the center of it. Anyone that wants to serve the front range needs to be here because there's nowhere else it can be serviced from.

When you look at our population growth, it was 9.6 percent from 2010 to 2015, and the country was 3.9 percent. People look at that and say, this place is growing. In addition, ecommerce is growing as a percentage of sales. It's still a little under 10 percent, but it's likely going to 20. And as more and more people shop online, you need more and more distribution square footage per person.

We're actually not overbuilding on the industrial side for all these changes. Denver has 5.2 million square feet under construction now. We've been 50 percent higher than that in previous cycles. We're No. 1 in the country for preleasing spec warehouse space. We have over 70 percent of our spec warehouse space accounted for before it delivers, whereas the country as a whole averages about 40 percent.

Is the Denver economy ready to weather the next downturn?

ALLISON: I feel reasonably comfortable with

Denver weathering a downturn. Banks have taken more conservative approaches to underwriting in recent years and borrowers have more equity invested.

Also, we've talked multiple times about in-migration, low unemployment and job growth. We've got strong demographics that are supporting a lot of these projects. I think, given all our strong market demographics and strong dynamics of Denver, we're in a good position.

PETE: You've got this kind of mixed match, when the economy in a consumer-based recession like we had last time. What you saw in the last recession was unemployed people choosing to move to Denver. They didn't have a job anyway, so why not move to the place where they really want to live? Denver maintaining its reputation for quality of life is important. We already talked about pricing – we're no longer competing with the same cities that we used to from a cost-of-living standpoint.

When we talk to different industries, the financial industry, for one, is saying we just feel there's the highest pool of candidates here, or those that are willing to relocate here, than just about everywhere else we look. So they are making big bets when you look around at some of these companies.

All of the major financial services players are in Denver. We also have aerospace, and we have technology.

JAY: I do focus on making sure we're attractive to educated millennials. We're not doing as good a job as we as we could be educating our own homegrown folks, so maintaining that influx is going to be important. Also from a hospitality standpoint, I look at I-70 traffic and wonder, at what point does that start to impact our tourism industry. It's a significant issue we've been trying to wrestle with for a long time. And all of the solutions that have been pitched have been very expensive. So, at what point do people start shifting further from Colorado towards Salt Lake City – where traffic is much less a concern – for their ski trips from the coast?

I generally think we're positioned very well. I think we handled the last downtown better than many markets did, and I think we're more diverse now.

Are you seeing people that are signing leases, on the demand side of the equation, getting markedly better terms and flexibility that would enable them to better weather a downturn?

JAY: In the retail context, we've seen more tenant-favorable terms than in the office market, especially with new development. As a developer or sponsor, you'll want to feel pretty comfortable if you're going into a development of a retail center, right now.

ALLISON RECKER
Senior Vice President
UMB

Allison Recker is a Senior Vice President in UMB's Commercial Real Estate group. She is responsible for managing the commercial real estate portfolio in Denver-metro, expanding business relationships in the area, and sourcing, underwriting and closing loans. Recker is well versed in lending on several property types including: multifamily, office, retail, self-storage and mixed use.

Recker joined UMB in 2015 and has 14 years of experience in commercial real estate lending. Prior to UMB, she was a senior vice president in commercial real estate lending at Vectra Bank. She earned a bachelor's degree in finance with a concentration in real estate from the University of Illinois – Urbana/Champaign.

JAY W. PHILP
Attorney at Law
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Jay Philp represents clients in all phases of real estate acquisition, development, leasing, financing and sales. Jay represents owners, private developers, master redevelopers and REIT affiliates on office, medical office, hotel, resort, multifamily, mixed-use, retail and industrial projects located throughout the United States. He also represents purchasers of portfolios of bank-owned REO properties and individual REO or distressed assets. In addition, he has represented purchasers of real estate loans and conducted foreclosures.

Jay practiced real estate law in Florida and in Massachusetts before moving to Denver. In Denver, prior to joining the firm, Jay was a senior consultant and broker with Aon Risk Services, advising financial institutions including insurance companies, fund complexes and banks on management liability insurance products, and brokering and negotiating directors' and officers', employment practices, fiduciary, errors and omissions and crime insurance contracts.

PETE SCHIPPITS
Senior Managing Director
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Pete Schippits is the Senior Managing Director and Market Leader for the Colorado region. In this role, he oversees all CBRE service lines spanning five offices in Colorado and approximately 600 employees. He is also a member of CBRE's Americas Operations Management Board. Through strategic leadership, Pete works to advance the brand and reinforce how CBRE builds real advantage for its clients.